IASB/FASB Meeting
Week commencing 13 June 2011

IASB Agenda reference	**3E**
FASB Agenda reference	**70E**

Staff Paper

Project	**Insurance Contracts**
Topic	**Acquisition costs revisited**

Purpose of this paper

1. On 2 February 2011, the boards tentatively decided that the contract cash flows should include those acquisition costs that relate to a ***portfolio*** of insurance contracts. On 2 March 2011, the IASB and FASB came to different tentative decisions on defining which acquisition costs could be included in the contract cash flows. This paper:

   (a) Provides background about the treatment of acquisition costs in the IASB's exposure draft *Insurance Contracts* (the ED) and the FASB's discussion paper *Preliminary Views on Insurance Contracts* (the DP)

   (b) Describes the different tentative decisions that the boards reached

   (c) Sets out the reasons supporting each decision

   (d) Asks the boards whether in the light of the fuller explanation of the reasons, they continue to support their earlier tentative decisions.

   (e) Should be read together with Agenda paper 3F / 70F. This compares the tentative decisions on acquisition costs reached in the projects on revenue recognition, leases, and insurance contracts. It also compares the activities of an insurer in acquiring new or renewal business to costs incurred in fulfilling a contract under the revenue recognition project and the existing inventory standards.

This paper has been prepared by the technical staff of the IFRS Foundation and the FASB for discussion at a public meeting of the FASB or the IASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the FASB or the IASB.

Comments made in relation to the application of U.S. GAAP or IFRSs do not purport to be acceptable or unacceptable application of U.S. GAAP or IFRSs.

The tentative decisions made by the FASB or the IASB at public meetings are reported in FASB *Action Alert* or in IASB *Update*. Official pronouncements of the FASB or the IASB are published only after each board has completed its full due process, including appropriate public consultation and formal voting procedures.

Acquisition costs – background

The ED proposals

2. The measurement model proposed in the ED/DP calibrates the initial measurement of an insurance contract to the premium paid by the policyholder and proposes that acquisition costs incurred by the insurer at the contract level should be included in the contract cash flows. The amount of any acquisition costs reduces the residual/composite margin at initial recognition of the contract, as illustrated in example 1:

Insurer A issues contract A for premium of CU100 and incurs acquisition costs of CU4. Assume risk adjustment = CU0. Expected PV of fulfilment cash flows = CU90					
At initial recognition (before the insurer receives the premium or pays the acquisition costs):			Immediately after initial recognition, the insurer receives the premium and pays the acquisition costs		
EPV of cash flows			EPV of cash flows		
	Premiums	100		Premiums	-
	Acquisition costs	(4)		Acquisition costs	-
	Insurance cash flows	(90)		Insurance cash flows	(90)
Residual/composite margin		(6)	Residual/composite margin		(6)
Liability		**NIL**	Liability		**(96)**

3. The proposal in the ED/DP is based on the premise that the premium paid by the policyholder is set so that the insurer recovers the following items:

   (a) The costs of undertaking the obligation to pay for insurance coverage. The ED/DP proposes to measure this obligation as the present value of fulfillment cash flows (ie the cash flows, discount rate and (for the IASB) risk adjustment building blocks).

   (b) The expected profit in the contract for providing services (ie the residual/composite margin building blocks. For the IASB, the residual margin would relate to non-insurance services only.)

   (c) The costs incurred in selling, originating and underwriting the contracts the insurer issues (ie acquisition costs).

4. The proposal in the ED/DP follows the view that a faithful representation of the insurer's liability from an insurance contract should reflect only the amounts described in paragraph 3(a) and 3(b). In other words, the amount implicitly paid by the policyholder for acquisition costs is not part of the representation of the liability. The rationale is illustrated in example 2:

Example 2:

Consider two contracts with the same contractual terms, risk profile and servicing effort. The contracts are originated in different ways (for example, Contract A through a sales force and Contract B on the internet), so that the acquisition costs for Contract A are much higher than the costs for Contract B. Assume in this example that the risk adjustment is nil. The contracts have the following expected cash flows:

Contract A:

- premium of CU100
- acquisition costs = CU4
- EPV of cash flows = CU90

Contract B:

- premium of CU97
- acquisition costs = CU1
- EPV of cash flows = CU90

In both cases, the obligation to fulfil the contract is CU90 and the expected profit from the contract is CU6. Should there be any difference in the initial measurement of those obligations?

Many existing accounting models measure insurance liabilities initially at the amount of the premium received, with deferral of acquisition costs. Such models treat acquisition costs as representing the cost of a recognizable asset, which, depending on the model, might be described as an asset relating to the contract or a customer relationship intangible asset. That would mean that for the two contracts, an insurer would recognise

Contract A:

A liability of CU100

A deferred asset of CU4

Contract B:

A liability of CU97

A deferred asset of CU1

However, the ED/DP proposed that no deferred asset is recognised. Instead, the insurer would recognise only the liability for the expected present value of cash flows plus the residual/composite margin. This means that under the ED/DP, the insurer recognises a liability of CU96 for contract A and CU96 for contract B. The acquisition costs are not deferred. If anything is deferred it is the net of premium less acquisition costs.

5. As discussed in the meetings leading to the ED/DP, another way to achieve this would be to recognise, at initial recognition:

    (a) A liability of CU96

    (b) Expense of CU4 for the acquisition costs and income of CU4 for the part of the premium that covered the acquisition costs.

The acquisition costs that are included in the cash flows

6. Acquisition costs were defined slightly differently in the IASB's ED and the FASB's DP:

    (a) The ED defined acquisition costs as the ***costs*** of selling, underwriting and initiating an insurance contract.

    (b) The DP defined acquisition costs as the ***direct and indirect costs*** of selling, underwriting and initiating an insurance contract.

7. The ED/DP proposed that the contract cash flows should include only those acquisition costs that are ***incremental to an individual insurance contract*** because those costs can be clearly identified as relating specifically to the contract. The reasons given for limiting the contract cash flows to incremental acquisition costs were that:

    (a) determining whether other costs are directly related to the contract can be more subjective; and

    (b) such an approach is consistent with that applied for transaction costs in the financial instruments standards in both IFRSs and US GAAP.

8. However, the comment letters generally objected to this proposal because it would exclude from the cash flows acquisition costs that are incurred at a portfolio level, but would not be incremental to the individual contracts. They stated that:

   (a) such an approach would resolve concerns that an insurer would include different costs (and hence measure an insurance contract differently) depending on whether it originated contracts through a commission-based sales force or salaried employees.

   (b) a portfolio approach is consistent with the way in which insurers price and manage their business. Many costs relating to the origination of contracts – such as underwriting, medical and inspection, and policy issuance – are measured and managed at the portfolio level, rather than at the individual contract level.

   (c) determining acquisition costs to be included in the contract cash flows at a portfolio level would be consistent with the unit of account used for measurement in the model as a whole.

Previous IASB and FASB decisions

9. On 2 February 2011, the boards tentatively decided that the contract cash flows should include those acquisition costs that relate to originating a ***portfolio*** of insurance contracts, for the reasons given in paragraph 8.

10. On 2 March 2011, the boards reached different tentative decisions about the types of acquisition costs that could be included in the contract cash flows.

    (a) The FASB tentatively decided that the acquisition costs included in the cash flows of insurance contracts should be limited to:

        (i) those costs related to ***successful*** acquisition efforts; and

        (ii) ***direct*** costs that are related to the acquisition of a portfolio of contracts.

    (b) The IASB tentatively decided that the acquisition costs to be included in the initial measurement of a portfolio of insurance contracts should be all the ***directly attributable*** costs that the insurer will incur in

acquiring the contracts in the portfolio. Directly attributable costs would include direct costs and allocations of some indirect costs, such as rent. No distinction would be made between successful efforts and unsuccessful efforts.

11. The FASB's tentative decision is consistent with Update 2010-26. Update 2010-26 was issued by the FASB in October 2010 and is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2011. See Appendix D for details of Update 2010-26.

12. Both boards also directed the staff to develop application guidance on acquisition costs. Draft application guidance for the IASB's tentative decisions is included in Appendix A and for the FASB's tentative decisions is included in Appendix B.

13. The following example illustrates the different consequences of the IASB and FASB decisions.

Example 3

As in examples 1 and 2, insurer A issues Contract A for premium of CU100 and incurs acquisition costs of CU4. Assume that insurer A has a 25% success rate, ie the acquisition costs comprise CU1 for successful efforts and CU3 for unsuccessful efforts. At initial recognition, the residual margin would be determined as follows:

	Applying IASB view:	**Applying FASB view:**
EPV of cash flows		
Premiums	100	100
Acquisition costs (successful)	(1)	(1)
Acquisition costs (unsuccessful)	(3)	-
Insurance cash flows	(90)	(90)
Residual/composite margin	6	9

After initial recognition, in both cases, the insurer would still pay CU4 of acquisition costs. If only successful efforts are included in the cash flows, the insurer would recognise an expense of CU3 and update the cash flows by CU1. If both successful and unsuccessful efforts were included in the cash flows, the insurer would update the cash flows by CU4.

If only successful efforts are included in the cash flows, the residual margin to be allocated would be CU9. If both successful and unsuccessful efforts are

included in the cash flows, the residual margin would be CU6. However, the expected overall profitability of the contract under both views would be CU6.

Basis for IASB's decision

14. The IASB tentatively decided that the acquisition costs to be included in the initial measurement of a portfolio of insurance contracts should be all the costs that the insurer will incur in acquiring the contracts in the portfolio. In other words, the IASB would include:

    (a) The costs of both successful *and unsuccessful* efforts in the contract cash flows; and

    (b) Both direct costs *and indirect costs that can be directly attributed* in the contract cash flows.

15. In support of the IASB tentative decision to include the costs of both successful *and unsuccessful* efforts in the contract cash flows, the IASB staff argue that:

    (a) as described in paragraphs 2-5, the measurement model in the ED/DP aims to measure the insurance contract liability at the amount remaining after excluding acquisition costs from the premium at inception. That liability aims to measure the obligation to provide insurance coverage and the future expected profitability for non-insurance services (ie the residual margin). Insurers price their contracts to recover all acquisition costs. If the contract cash flows excluded acquisition costs for unsuccessful efforts, the insurer would overstate the amount of the residual margin (ie the margin would include costs in addition to expected profit) and therefore overstate the overall liability. Such an outcome is illustrated in Example 3.

    (b) On 2 February 2011, the boards concluded that the contract cash flows should include those acquisition costs relating to a portfolio of contracts. (The reasons for that conclusion are set out in Appendix C.) The IASB staff believe that the costs of originating a portfolio of contracts necessarily include costs that could be attributed to

unsuccessful efforts: in originating a portfolio, the insurer must attempt to originate numerous contracts, and some of those attempts are not successful. Although those contracts would not be in the portfolio, the costs of all attempts are necessary to assemble the portfolio of successful contracts. Moreover, following the logic set out in paragraph 4, the initial measurement of the insurance contract liability should exclude the amounts implicitly paid by the policyholder for all acquisition costs, because if the insurer is rational, it must, at least in the long run price to recover all its acquisition costs.

(c) including only the costs of successful efforts would impair comparability between insurers that use different means of acquiring contracts. One reason for the boards' decision that acquisition costs should be determined at a portfolio level was to eliminate differences between insurers with different distribution systems. In other words, the decision was intended to ensure that insurers would recognise the same liability regardless of whether they:

  (i) perform contract acquisition services in-house and incurs internal agent commission and/or salaries;

  (ii) source services externally and pay commissions to third-party agents; or

  (iii) use direct response advertising and incur related costs.

  In the IASB staff's view, restricting acquisition costs to those related to successful efforts would defeat the main purpose of measuring acquisition costs at a portfolio level. An insurer using third party agents would nominally pay commissions only on successful sales and would include all commissions in the cash flows. However, in reality, those commissions would be set at a rate to recover the costs of both successful and unsuccessful sales. Thus, an insurer that uses third party agents would incur higher 'successful' costs than one using an internal salaried workforce, even though their total costs might be similar.

(d) limiting the acquisition costs to those for successful efforts only, as in the FASB's tentative decision, would also impair comparability between insurers that perform contract acquisition activities 'in house' but using different techniques. Suppose one insurer spends 8 hours per proposal and has an 80% success rate and another insurer spends 5 hours per proposal and has a 50% success rate. Both would obtain 4 contracts from 40 hours' work. However, applying a successful efforts approach, the first would treat the costs of 32 hours as contract cash flows, whereas the second would treat the costs of only 20 hours as contract cash flows. (See counter argument in paragraph 21)

16. In support of the IASB tentative decision to include both direct *and indirect* acquisition costs that are directly attributable in the contract cash flows, the IASB staff argue that:

(a) insurers take indirect costs into account when pricing their contracts. As explained in paragraph 15(a), excluding such costs from the contract cash flows, when those costs can be attributed to those contracts, would lead to an overstatement of the residual margin.

(b) as explained in paragraph 15(c), excluding some acquisition costs from the contract cash flows would impair comparability between insurers that use different methods for acquiring contracts. An insurer that uses external agents might have higher direct and lower indirect costs—and as a consequence would recognise smaller liabilities—than an insurer that performs its own acquisition activities, even although their total contract acquisition costs might be similar.

(c) the costs of acquisition activity should be determined in the same way as the costs of fulfilment activity. In other words, just as the costs of fulfilment activity will include all directly attributable costs that are necessary for fulfilling contracts, the costs of acquisition activity should include all directly attributable costs that are necessary for acquiring the contracts. Such consistency is not only conceptually logical. It also eliminates any difficulties in distinguishing between fulfilment and acquisitions costs, given that both are included in the

contract cash flows. This is of particular relevance for recurring acquisition costs, such as trail commissions. It can sometimes be difficult to distinguish such costs from the other costs of fulfilling the contracts and there would be no need to do so if they were treated consistently.

(d) the insurance contracts standard will include extensive guidance on identifying contract cash flows. The latest IASB draft guidance is set out in Appendix A to this paper. This guidance will identify the types of costs (both fulfilment and acquisition costs) that would be regarded as 'directly attributable'. It is consistent with well-established guidance in other standards that require inclusion of some indirect costs (such IAS 2 / FASB Topic 330 *Inventories*). Consequently, the IASB staff see no reason why a requirement to include all directly attributable costs should be unduly subjective or lead to greater diversity in practice than a requirement to include only direct costs.

17. The IASB staff acknowledge that including some indirect costs and the costs of unsuccessful efforts in the contract cash flows would create differences between the insurance contracts standard and the revenue recognition standard. Entities applying the revenue recognition standard would treat indirect acquisition costs and the costs of unsuccessful acquisition efforts as marketing expenses of the period, whereas entities applying the insurance contract standard would deduct these costs from the measure of the liability. However, in the IASB staff's view, fundamental differences between the two models justify the different requirements for acquisition costs. The revenue recognition model aims to allocate customer consideration and recognise acquisition costs only to the extent that they represent a recoverable asset, and that asset is regarded as separate from the contract. In contrast, the insurance contract model aims to measure the entity's remaining liabilities, with a residual margin that represents only the expected profit on the contract. The insurance contract model tests whether the premium is sufficient to recover all the acquisition costs and all the expected fulfillment costs through the requirement that the residual or composite margin cannot be negative.

Basis for FASB's decision

18. The FASB's view is that the acquisition costs included in the cash flows of insurance contracts should be limited to:

    (a) those costs related to successful acquisition efforts; and

    (b) direct costs that are related to the acquisition of a portfolio of contracts.

19. Applying the FASB's view, costs incurred that did not result in a contract (failed acquisition costs) are not fulfilment costs of the portfolio of successful contracts and, instead, are simply costs of doing business that represent period expenses. This view is consistent with the decisions reached on acquisition costs in the revenue recognition project.

20. This view results from the following conclusions:

    Successful acquisition efforts

    (a) costs relating to unsuccessful contract acquisition efforts cannot be considered to provide a future economic benefit to warrant recognition and cannot be considered to be recoverable. Including acquisition costs in the measurement of the liability is in effect treating those costs as a contra-liability, therefore notions of recoverability are equally relevant.

    (b) Including only costs relating to successful acquisition efforts is consistent with the boards' intent in the basis for conclusions in the ED which proposed to limit the acquisition costs to be included in the cash flows to those costs that can be clearly identified as relating specifically to contracts issued.

    (c) This is also consistent with the boards' tentative decision to include costs that an insurer will incur directly in fulfilling a portfolio of insurance contracts in the cash flows used to measure the insurance liability. A *portfolio of insurance contracts* is defined in the ED and the DP as "insurance contracts that are subject to broadly similar risks and managed together as a single pool". Therefore, that definition

inherently would limit the costs that would be included to be those costs related to successful acquisition efforts.

(d) In addition, including only costs relating to successful acquisition efforts is consistent with other projects. The unit of measurement, whether the individual contract or portfolio of successful contracts, should have no bearing on the decision related to how period expenses should be recognized.

Direct costs

(e) The directly attributable costs (including direct and allocated indirect costs) related to a portfolio of contracts are too broad and general allocated costs that are needed to operate a business (e.g., overhead) and obtain potential policyholders, should be recognized in the period incurred, even if those costs are associated with the acquisition functions.

(f) Insurers, like companies in all other industries, price their product to recoup all their costs. The notion of marketing and selling efforts is not different for insurance than many other businesses that have more than insignificant selling efforts and costs.

(g) Determining which costs to expense and which costs to include in the contract cash flows is subjective and has lead to diversity in practice. Some could argue that costs attributable to acquiring new contracts or renewing contracts include a portion of senior executive compensation, training on new products, etc. The question becomes where the cut-off should be the further the functions and costs are from the direct interaction with the policyholder and the application and written policy.

21. The FASB staff believe limiting acquisition cost treatment to successful contracts (i.e., the portfolio) provides more transparent information about the efficiency and effectiveness of the insurer's selling efforts (success rate) and is useful when comparing insurers. For example, if one insurer is more efficient in writing successful contracts than another insurer and obtains 80 percent of

efforts as successful contracts while another insurer only obtains 50 percent as successful contracts, assuming the same amount of effort (hours) and that insurance is a competitive market and therefore pricing will be similar, those insurers will not have comparable measurement of insurance contracts at initial recognition and in subsequent periods because of the effect on the residual (or composite) margin of including acquisition costs in the contractual cash flows. If one entity spends less time than another entity, this would not necessarily translate into a difference in successful versus unsuccessful contracts but typically results in worse business being written and higher loss ratios for the successful contracts. (See counter argument in paragraph 15(d))

22. The FASB staff believes that limiting the acquisition costs included in the cash flows to successful efforts and direct costs results in a faithful representation of the remaining liability.

    (a) The boards' tentative decisions require insurers to determine the expected present value of the cash flows. The IASB board tentatively decided to include an explicit risk adjustment. Neither of these items should be impacted by the acquisition costs.

    (b) The boards tentatively decided to recognize the difference between the expected present value of cash inflows less the expected present value of cash outflows (plus a risk adjustment under the IASB's tentative decision) as a residual or single margin to defer day one gains. It was not the intent for the residual or single margin to include all costs that are priced for in a contract that are not included elsewhere in the contractual cash flows (which would result in no period costs). Therefore the residual margin and single margin represent the profit that is available to cover all other operating expenses and some profit. To reduce the residual margin and single margin for acquisition costs for unsuccessful contracts and allocated indirect costs at initiation of the contract would not portray the profitability of the actual contracts sold.

Questions for boards

23. The IASB's tentative decision is that

    (a) the acquisition costs to be included in the initial measurement of a portfolio of insurance contracts should be all the directly attributable costs that the insurer will incur in acquiring the contracts in the portfolio.

    (b) No distinction should be made between successful efforts and unsuccessful efforts nor between direct costs and indirect costs that are directly attributable.

24. The FASB's tentative decision is that the acquisition costs included in the cash flows of insurance contracts will be limited to:

    (a) those costs related to successful acquisition efforts; and

    (b) direct costs that are related to the acquisition of a portfolio of contracts.

Which acquisition costs?

In the light of the fuller explanation of the reasons in this paper and the background provided in agenda paper 3F/70F, do the boards wish to retain, modify or reject their earlier tentative decisions? In particular:

1. If the boards want to retain or modify their tentative decisions, should the acquisition costs included in the initial measurement of a portfolio of insurance contracts be:

    a. all directly attributed costs that the insurer will incur, or direct costs only;

    b. those that relate only to successful acquisition efforts, or both successful and unsuccessful acquisition efforts?

2. If the boards wish to reject their earlier tentative decisions, should the acquisition costs included in the initial measurement of a portfolio of insurance contracts be:

    a. consistent with the costs capitalised in the boards' tentative decisions for leases and the FASB's financial instruments standards?

    b. consistent with the costs capitalised for acquisition costs in the boards' tentative decisions for revenue recognition

and in IFRS 9?

c. include costs for producing/customising the insurance contract and therefore be consistent with the costs capitalised in the inventory and construction contracts standards under US GAAP and IFRS and the boards' tentative decisions in the revenue recognition project for pre-acquisition contract fulfilment costs?

d. a modification of either 2(a) or 2(b):

   i. to include additional costs in the expected cash flows; and/or

   ii. to allow for costs incurred in the acquisition activity on unsuccessful contracts to be included in the measurement of the expected cash flows?

25. When Board members decide how to answer the above questions, we suggest that they refer to Agenda paper 3F / 70F. This compares the tentative decisions on acquisition costs reached in the projects on revenue recognition, leases, and insurance contracts. It also compares the activities of an insurer in acquiring new or renewal business to costs incurred in fulfilling a contract under the revenue recognition project and the existing inventory standards.

Appendix A – draft application guidance for the IASB

26. On 18 February, the boards tentatively decided:

    (a) to clarify that all costs that an insurer will incur directly in fulfilling a portfolio of insurance contracts should be included in the cash flows used to determine the insurance liability, including:

    (i) costs that relate directly to the fulfilment of the contracts in the portfolio, such as payments to policyholders, claims handling, etc (described in paragraph B61 of the ED);

    (ii) costs that are directly attributable to contract activity as part of fulfilling that portfolio of contracts and that can be allocated to those portfolios; and

    (iii) such other costs as are specifically chargeable to the policyholder under the terms of the contract.

    (b) to confirm that costs that do not relate directly to the insurance contracts or contract activities should be recognised as expenses in the period in which they are incurred;

    (c) to provide application guidance based on IAS 2 *Inventories* and IAS 11 *Construction Contracts*; and

    (d) to eliminate the term 'incremental' from the discussion of fulfilment cash flows that was proposed in the ED / DP (ie paragraph B61 of the ED).

27. On 1 March, the IASB tentatively decided the acquisition costs to be included in the initial measurement of a portfolio of insurance contracts should be all the costs that the insurer will incur in acquiring the contracts in the portfolio.

28. The text below shows how the IASB staff propose to reflect these decisions in the final IFRS. The text is marked up to show changes from the IASB's exposure draft.

Which cash flows?

B61 Estimates of cash flows in a scenario shall include all cash flows within the boundary of an existing contract, assessed ~~that are incremental~~ at the level of a

portfolio of insurance contracts, and no others. The cCash outflows that are incremental to a portfolio of insurance contracts shall include:

(a) direct costs and systematic allocations of costs that relate directly to the acquisition and fulfilment of the insurance contracts in a portfolio or

(b) costs that are directly attributable to contract acquisition and contract fulfilment activityies as part of acquiring and fulfilling that portfolio of contracts and that can be allocated on a rational and consistent basis to the individual portfolios of insurance contracts.

(c) such other costs as are specifically chargeable to the policyholder under the terms of the contract.

B61A Costs that are attributable to contract acquisition and contract fulfilment activity include the labour and other costs of personnel directly engaged in contract acquisition and contract fulfilment activities, including supervisory personnel, and a systematic allocation of *directly attributable* fixed and variable overheads that are incurred in acquiring and fulfilling a portfolio of insurance contracts. These costs relate to contract acquisition and contract fulfilment activities and not necessarily costs directly related to an individual insurance contract. Fixed overheads are those indirect costs of contract acquisition and contract fulfilment activities that remain relatively constant regardless of the volume of contract acquisition or contract fulfilment activity, such as accounting, human resources, IT technology and support, building rent and maintenance. Variable contract acquisition and contract fulfilment activity overheads are those indirect costs that vary directly, or nearly directly, with the volume of contracts or contract acquisition and contract fulfilment activities, such as general overhead costs associated with servicing policyholders. Those fixed and variable overheads that cannot be directly attributed do not related to contract acquisition and contract fulfilment activities.

B61B Similarly, contract acquisition and contract fulfilment activity costs are allocated to portfolios of insurance contracts using methods that are systematic and rational and that are applied consistently to all costs that have similar characteristics. This allocation is based on the normal activity of the insurer. Normal activity is the level of contract acquisition and contract fulfilment activity expected to be achieved on average over a number of periods under normal circumstances, taking into account any reduction in activity resulting from deliberate changes in strategy. The actual level of contract acquisition and contract fulfilment activity may be used if it approximates normal capacity. The amount of fixed overhead allocated to each portfolio level is not increased as a consequence of low contract acquisition and contract fulfilment activities that are due to inefficiencies. Unallocated general overheads are recognised as an expense in the period in which they are incurred. In periods of abnormally high contract acquisition and contract fulfilment activities, the

amount of fixed overhead allocated to each portfolio is decreased so that the costs included in the cash flows used to measure portfolios of insurance contracts do not exceed costs incurred. Overhead costs that vary with contract acquisition and contract fulfilment activity are allocated to each portfolio on the basis of the actual cost incurred.

B61A Accordingly, the relevant cash flows include:

(a) premiums (including premium adjustments and instalment premiums) from policyholders and any additional cash flows that result from those premiums.

(b) payments to (or on behalf of) policyholders, including claims that have already been reported but have not yet been paid (i.e. reported claims), claims that have already been incurred but have not yet been reported (IBNR) and all future claims and other benefits under the existing contract.

(c) claim handling costs (i.e. the costs that the insurer will incur in processing and resolving claims under existing insurance contracts, including legal and adjuster's fees and internal costs of processing claim payments).

(d) the costs that the insurer will incur in providing contractual benefits that are paid in kind.

(e) cash flows that will result from options and guarantees embedded in the contract, to the extent those options and guarantees are not unbundled (see paragraph 12). When insurance contracts contain embedded options or guarantees, it is particularly important to consider the full range of scenarios.

(f) the ~~incremental~~ costs of acquiring a portfolio of insurance contracts, ie the costs of selling, underwriting and initiating ~~an~~ the insurance contracts in a portfolio ~~for those contracts that have been issued and that the insurer has incurred because it has issued that particular contract (i.e. the incremental acquisition costs)~~. ~~Thus, these costs are identified at the level of an individual insurance contract rather than at the level of a portfolio of insurance contracts.~~

(g) policy administration and maintenance costs, such as costs of premium billing and costs of handling policy changes (e.g. conversions and reinstatements). Such costs also include recurring commissions expected to be paid to intermediaries if a particular policyholder continues to pay the premiums specified in the insurance contract.

(h) transaction-based taxes (such as premium taxes, value added taxes and goods and services taxes) and levies (such as fire service levies and guarantee fund assessments) that arise directly from existing insurance

contracts, or can be attributed to them on a reasonable and consistent basis.

(i) potential recoveries (such as salvage and subrogation) on future claims covered by existing insurance contracts and, to the extent they do not qualify for recognition as separate assets, potential recoveries on past claims.

(j) payments to current or future policyholders as a result of a contractual participation feature (including those features implied in the contract by regulatory or legal requirements) that provides policyholders with participation in the performance of a portfolio of insurance contracts or pool of assets.

B62 The following cash flows shall not be considered in estimating the cash flows that will arise as the insurer acquires and fulfils a portfolio of~~an~~ existing insurance contracts:

(a) investment returns. The investments are recognised, measured and presented separately. However, the measurement of a participating insurance liability is affected by the cash flows, if any, that depend on the investment returns.

(b) payments to and from reinsurers. Reinsurance assets are recognised, measured and presented separately.

(c) cash flows that may arise from future insurance contracts, i.e. cash flows that are outside the boundary of existing contracts (see paragraphs 26 and 27 [of the ED]), or from options, forwards and guarantees that do not relate to the existing insurance contract. Nevertheless, estimates of cash flows from existing contracts are not performed on a run-off basis. In other words, those estimates do not incorporate changes in the cash flows from existing contracts that could take place if the insurer stopped issuing new contracts, unless the insurer actually stops issuing new contracts.

(d) ~~acquisition costs other than incremental acquisition costs.~~

(e) cash flows arising from abnormal amounts of wasted labour or abnormal amounts of other resources used to fulfil the contract.

(f) costs that cannot be ~~do not relate~~ directly attributed to the contract or contract acquisition and contract fulfilment activities~~, such as general overheads~~.

(g) income tax payments and receipts. Such payments and receipts are recognised, measured and presented separately in accordance with IAS 12 *Income Taxes*.

(h) cash flows between different components of the reporting entity, such as between policyholder funds and shareholder funds.

(f) cash flows arising from components that are unbundled from the insurance contract (e.g. interest that the insurer expects to credit to policyholder account balances). See paragraphs 8 and 9 [of the ED].

B62A Costs that cannot be attributed to a portfolio of insurance contracts are excluded in measuring insurance contracts and recognised as expenses in the period in which they are incurred. Examples of such costs are:

(a) any inefficiencies related to contract acquisition and contract fulfilment activities, such as under-absorption of costs if the work-force is not working at full capacity;

(b) administrative overhead costs that do not contribute to acquiring or fulfilling insurance contracts; and

(c) product development and training costs.

B63 Some costs that arise from contract acquisition and contract fulfilment activity may relate to ~~relate directly to insurance contracts or contract activities but are the result of activities that cover~~ more than one portfolio. This is the case, for example, when one department services ~~(e.g. salaries of staff of a~~ claims handling procedures for ~~department working on~~ two or more ~~than one~~ portfolios~~)~~. ~~An~~ When the costs for each portfolio are not separately identifiable, an insurer shall allocate those costs~~, other than acquisition costs (see paragraph B61(f)),~~ on a rational and consistent basis to individual portfolios of insurance contracts. Even though such costs are allocations, they ~~are~~ still ~~incremental~~ relate directly to the acquisition or fulfilment of the ~~at the~~ portfolio of insurance contracts. ~~level. Costs that are not incremental at the portfolio (or lower) level because they do not relate directly to the insurance contract or contract activities, such as general overheads, are not allocated to portfolios and therefore are not included in the measurement of insurance contracts.~~

Appendix B – draft application guidance for the FASB

1. On 1 March, the FASB tentatively decided that the acquisition costs included in the cash flows of insurance contracts should be limited to:
   (a) those costs related to successful acquisition efforts; and
   (b) direct costs that are related to acquisition of a portfolio of contracts.
2. The text below shows the FASB's staff proposed application guidance on which acquisition costs should be included in the cash flows of insurance contracts:
   (a) Direct costs of contract acquisition that may be included in the cash flows include:
      (i) Compensation (and compensation related costs) for and costs incurred by (such as travel related activities) the people performing functions directly related to acquiring new or renewal contracts including
         (1) Underwriting,
         (2) Sales force contract selling,
         (3) Medical and inspection, and
         (4) Policy issuance
      (ii) An agent or broker commission or bonus for successful contract acquisition or acquisitions.
      (iii) Medical and inspection fees for successful contract acquisition or acquisitions.
   (b) Costs for software dedicated to contract acquisition are not eligible to be included in cash flows. Such costs are not other costs related to those activities that would not have been incurred but for that contract under the definition of that term.
   (c) Other costs, some of which entities may consider acquisition-related costs that should be expensed as incurred include:
      (i) Soliciting potential customers
      (ii) Market research

(iii) Training

(iv) Administration

(v) Unsuccessful acquisition or renewal efforts

(vi) Product development.

(d) An insurer also would expense as incurred any indirect costs. Such costs include all of the following:

(i) Administrative costs

(ii) Rent

(iii) Depreciation

(iv) Occupancy costs

(v) Equipment costs (including data processing equipment dedicated to acquiring insurance contracts)

(vi) Other general overhead.

3. In addition, the FASB would treat separately the application guidance on fulfilment cash flows which would be broadly consistent with the drafting in Appendix A, excluding the references to contract acquisition activity.

Appendix C – Extract from Agenda paper 3F from the meeting in the week of 14 February

Which cash flows?

Staff analysis and recommendation

30 In the staff's view the requirements on general overhead costs should be consistent with both IFRSs and US GAAP, which require some direct general overhead costs to be allocated to:

(a) inventory (IAS 2 *Inventories* and Topic 330 *Inventory* of the FASB's Accounting Standards Codification); and

(b) contract costs in construction contracts (IAS 11 *Construction contracts* and Subtopic 605-35 *Revenue Recognition Construction-Type and Production-Type Contracts*).

[...]

31. As discussed in paper 3A (*Project assumptions*) the principle in the ED is that the cash flows that are incorporated in the measurement of the insurance liability are those that will arise as the insurer fulfils the insurance contract. In paper 3A we also ask the boards to confirm the assumption that the final standard will measure insurance contracts at the portfolio level. Therefore, the measurement of an insurance contract should include cost directly related to the contract or the contract activities, determined on a portfolio basis.

32. Some general overheads are directly required to fulfil the insurance contract, when considered at a portfolio level. For example, if a rented office is used entirely to service policyholders in a single portfolio, the rent and associated costs relate directly to the portfolio. Similarly, some IT technology and support costs relate only to claims handling. In the staff's view, the boards should define costs that relate directly to contract activities consistently with IAS 2/Topic 330 and IAS 11/Subtopic 605-35. Such costs would include:

(a) costs that relate directly to the fulfilment of the contracts in the portfolio, such as payments to policyholders, claims handling, etc (described in paragraph B61 of the ED);

(b) costs that are attributable to contract activity in general and that can be allocated to the contracts in the portfolio; and

(c) such other costs as are specifically chargeable to the policyholder under the terms of the contract.

33. Paragraphs 57 and 58 of *Revenue from Contracts with Customers* propose that costs that relate directly to the fulfilment of a contact are capitalised if they generate or enhance resources to be used in satisfying performance obligations. Therefore, including in the measurement of a portfolio of contracts those costs that relate directly to the fulfilment of that portfolio of contracts would also be consistent with the proposals in the ED *Revenue from Contracts with Customers*.

34. Applying the approach described in IAS 2/Topic 330 and IAS 11/Subtopic 605-35, costs that are attributable to contract activity include the labour and other costs of personnel directly engaged in contract activities, including supervisory personnel, and a systematic allocation of attributable fixed and variable overheads that are incurred in fulfilling a portfolio of insurance contracts. These costs relate to *contract activities* and not necessarily costs directly related to an individual insurance contract. Fixed overheads are those indirect costs of contract activities that remain relatively constant regardless of the volume of contract activity, such as accounting, human resources, IT technology and support, building rent and maintenance. Variable contract activity overheads are those indirect costs that vary directly, or nearly directly, with the volume of contract or contract activities, such as general overhead costs associated with servicing policyholders.

35. Similarly, contract activity costs are allocated to portfolios of insurance contracts using methods that are systematic and rational and that are applied consistently to all costs that have similar characteristics. This allocation is based on the normal capacity of the insurer. Normal capacity is the level of contract activity expected to be achieved on average over a number of periods

under normal circumstances, taking into account the loss of capacity resulting from deliberate changes to the servicing strategy. The actual level of contract activity may be used if it approximates to normal capacity. The amount of fixed overhead allocated to each portfolio level is not increased as a consequence of low contract activities that are due to inefficiencies. Unallocated general overheads are recognised as an expense in the period in which they are incurred. In periods of abnormally high contract activities, the amount of fixed overhead allocated to each portfolio is decreased so that the costs included in the cash flows used to measure portfolios of insurance contracts do not exceed costs incurred. Overhead costs that vary with contract activity are allocated to each portfolio on the basis of the actual cost incurred.

36. Some overhead costs that arise from contract activity may relate to more than one portfolio. This is the case, for example, when one department services claims handling procedures for two or more portfolios. When the costs for each portfolio are not separately identifiable, they are allocated between the portfolios on a rational, systematic and consistent basis.

37. Costs that cannot be attributed to a portfolio of insurance contracts are excluded in measuring insurance contracts. Examples of costs that are excluded from the cost of insurance contracts and that are recognised as expenses in the period in which they are incurred, are:

    (c) abnormal amounts of contract activity costs;

    (d) any inefficiencies related to contract activities, such as under-absorption of contract activity costs if the work-force is not working at full capacity;

    (e) general administrative overhead costs that do not contribute to fulfilling insurance contracts; and

    (f) product development and selling costs (other than those acquisition costs included in the measurement of insurance contracts. We will ask the boards to discuss acquisition costs again at a future meeting).

38. Similar to other industries, insurers price their products to recoup all of their costs and make a profit. The identification and allocation of general overhead

costs that should be included in the expected cash flows is inherently subjective. Inconsistencies in treatment will affect the measurement of the insurance contract liabilities; the level of the residual margins (refer to paragraph 47 of this paper for more detail) and comparability in general. Furthermore, the treatment of general overhead costs can allow for potential abuse, particularly if sufficient guidance is not provided.

39. Some suggest that only general overhead costs that relate to specified functions should be considered as direct costs. However, in the staff's view, determining which function should be treated as direct would be arbitrary. It is unclear why costs included in one function would be considered as direct when the same costs included in a different function would not be considered direct. Furthermore, it should be consistent with the principle that cash flows incorporated in the measurement of the insurance contract are those that will arise as the insurer fulfils the insurance contract or contract activities.

40. In the staff's view, the boards need to strike a balance between meeting the principle that the fulfilment cash flows include all those required to fulfil the contract, and the potential for reduced comparability that might arise. In addition, there is a risk that including additional costs in the cash flows could make the expected cash flow meaningless to users when analysing the actual underwriting and expense results. However, the staff note that the discussions of direct cost in existing standard has been successfully implemented in practice for some time.

41. Finally, the ED refers to the costs that are included in the fulfilment cash flows as costs that are 'incremental' to a portfolio of insurance contracts. Paragraph B61 defines (in effect) incremental to include 'direct costs and systematic allocations of costs that relate directly to the insurance contract or contract activities'. We therefore cannot see a difference between the meanings of 'direct' and 'incremental' and we recommend that the boards should eliminate the term 'incremental' in this context.

Appendix D – Recent FASB guidance in Update 2010-26 issued for acquisition costs of insurance contracts

D1. In October 2010, the FASB issued Update 2010-26, which is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2011. Under Update 2010-26, an insurance entity shall capitalize only the following as acquisition costs related directly to the successful acquisition of new or renewal insurance contracts:

(a) Incremental direct costs of contract acquisition.

(b) The portion of the employee's total compensation (excluding any compensation that is capitalized as incremental direct costs of contract acquisition) and payroll-related fringe benefits related directly to time spent performing any of the following acquisition activities for a contract that actually has been acquired:

(i) Underwriting

(ii) Policy issuance and processing

(iii) Medical and inspection

(iv) Sales force contract selling.

(c) Other costs related directly to the insurer's acquisition activities in (b) that would not have been incurred by the insurance entity had the acquisition contract transaction(s) not occurred.

(d) Advertising costs that meet the capitalization criteria in Subtopic 340-20, *Other Assets and Deferred Costs—Capitalized Advertising Costs* (that is, the costs of direct-response advertising shall be capitalized if the primary purpose of the advertising is to elicit sales to customers who could be shown to have responded specifically to the advertising and the direct-response advertising results in probable future benefits).

D2. Update 2010-26 provides further guidance on the incremental direct costs of contract acquisition that may be deferred:

(e) An agent or broker commission or bonus for successful contract acquisition or acquisitions.

(f) Medical and inspection fees for successful contract acquisition or acquisitions.

D3. Update 2010-26 clarifies that payroll-related fringe benefits include any costs incurred for employees as part of the total compensation and benefits program. Examples of such benefits include all of the following:

(a) Payroll taxes

(b) Dental and medical insurance

(c) Group life insurance

(d) Retirement plans

D4. Other costs related directly to the insurer's acquisition activities that would not have been incurred by the insurance entity had the acquisition contract transaction(s) not occurred, including all of the following:

(a) Reimbursement of costs for air travel, hotel accommodations, automobile mileage, and similar costs incurred by personnel relating to the specified activities

(b) Costs of itemized long-distance telephone calls related to contract underwriting

(c) Reimbursement for mileage and tolls to personnel involved in on-site reviews of individuals before the contract is executed.

D5. Update 2010-26 clarifies that costs for software dedicated to contract acquisition are not eligible to be included in deferred acquisition. Such costs are not other costs related to those activities that would not have been incurred but for that contract under the definition of that term.

D6. Update 2010-26 requires that an insurance entity shall expense as incurred any acquisition-related cost that cannot be capitalized in accordance with that Update. Such costs include costs of all of the following:

(a) Soliciting potential customers (except direct-response advertising capitalized in accordance with paragraph 944-30-25-1A(d))

(b) Market research

(c) Training

(d) Administration

(e) Unsuccessful acquisition or renewal efforts (except direct-response advertising capitalized in accordance with paragraph 944-30-25-1A(d))

(f) Product development.

D7. In addition, Update 2010-26 clarifies that an insurance entity shall expense as incurred any indirect costs. Such costs include all of the following:

(a) Administrative costs

(b) Rent

(c) Depreciation

(d) Occupancy costs

(e) Equipment costs (including data processing equipment dedicated to acquiring insurance contracts)

(f) Other general overhead.

D8. Finally, Update 2010-26 allows an entity to elect not to capitalize costs that the entity had not previously capitalized (if initial application of the amendments in that Update would result in the capitalization of acquisition costs that had not been previously capitalized).